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SUBJECT: FAULTLINES IN UKRAINE'S BANKING SYSTEM

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¶1. (SBU) Summary. IMF representatives indicated to us that the first diagnostic audits of Ukraine's banking sector were completed on January 22. In the IMF's view, the audits show that none of Ukraine's seventeen largest banks has enough capital to meet an expected deterioration of loan portfolios. While the IMF assumes foreign-owned subsidiaries will be able to raise enough capital to meet their expected shortfall, domestic banks may be hard pressed to do the same.

¶2. (SBU) The IMF and the World Bank expressed particular concern about regulatory and governance weaknesses at the National Bank of Ukraine (NBU), as more and more banks may require recapitalization or resolution in the near future. One key analyst expressed separately on January 23 that, despite the magnitude of potential bank failures and the need for immediate preventative action, Ukraine's financial watchdogs have thus far proven unable to generate an adequate policy response. End summary.

IMF and World Bank Anxious
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¶3. (SBU) At a meeting of IMF, World Bank, and USG representatives on January 22, the IMF's Engen Akcakoca told us that Phase I diagnostic studies of Ukraine's seventeen largest banks had been completed. The IMF team led by Ceyla Pazarbasioglu, which arrived in Kyiv this week for the first formal review of Ukraine's performance under the $16.4 billion Stand-By Arrangement (SBA), assumes that capital infusions will be required in all of Ukraine's largest banks, including seven subsidiaries of foreign banks, according to Akcakoca. The IMF expects that foreign-owned banks will receive capital from parent institutions, while domestic banks will rely primarily on shareholders and the NBU to meet increased capital requirements.

¶4. (SBU) External auditors are now reviewing Ukraine's next largest group of seventeen banks under a so-called Phase II diagnostic study. Their findings will be presented to the NBU on February 24. Phases III and IV of the diagnostic study, encompassing Ukraine's medium and small-sized banks, will be due at the end of May 2009. The NBU plans to use a simplified methodology for Phases III and IV, to be developed by the IMF's Akcakoca and likely funded by an EBRD grant.

¶5. (SBU) According to the IMF's Stand-By Arrangement, the NBU is to examine the auditors' reports and determine if, and how much, extra capital is needed at individual banks to absorb an expected deterioration of loan portfolios. If existing shareholders are unable or unwilling to provide the

additional capital, the NBU and GOU are to establish a mechanism for the GOU to recapitalize and/or take control of failing banks. However, foreign donors are concerned that little progress has been made in creating such a mechanism. At the January 22 meeting, World Bank country director Martin Raiser pointed out that the NBU and GOU have not yet even established bank recapitalization and liquidation units.

¶6. (SBU) While the Phase I-IV diagnostic process appears fine on paper, IMF and World Bank officials further worry that many banks could fail prior to the completion of Phase II-IV audits and before adequate legal, regulatory, and governance structures have been put in place. There is growing consensus, according to Raiser, that the international donor community itself should develop procedures for the recapitalization, restructuring, administration, and liquidation processes, since Ukraine's institutional and policy oversight bodies are sorely lacking in capacity and leadership. Raiser concluded, "We may have to design this for them," and he applauded the willingness of the IMF and U.S. Treasury to provide immediate technical assistance.

¶7. (SBU) Raiser decried the lack of transparent financial disclosure and reporting in Ukraine, since this may scare off potential private investors and force the GOU to undertake a "series of nationalizations." In addition to advocating new regulations for mergers and acquisitions, the IMF's Thordur Olaffson, in turn, revealed that the Fund had demanded published statements on banks' asset quality from the NBU. He said that the NBU had agreed to implement a framework for asset quality disclosure by the end of January, but that this



was a "large legal undertaking" which may not be completed before the IMF team departs on February 6.

Leading Analyst Also Worried
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¶8. (SBU) On January 23, Edilberto Segura, former World Bank country director and current President and Chief Economist at the Bleyzer Foundation, separately told us that NBU officials are now "so scared, they don't even know what to do." Segura said that, using IMF methodology, about 30 percent of loans could be classified as bad (i.e. "non-standard" or "doubtful" or "a loss"). However, the NBU continues to state officially that bad loans constitute just 1.5 percent of banks' loan portfolios. Segura believes that Minister of Finance Viktor Pynzenyk has been "stripped of power" within the government, even though "he understands the gravity of the situation." Likewise, the Ministry of the Economy "lacks both a fundamental understanding of the problem and the means to cooperate" with other government agencies. Segura's Foundation and its affiliate SigmaBleyzer, one of the leading private equity players in Ukraine, have resorted to holding closed door briefings, drawing up financial sector contingency plans for key members of parliament and the government's monetary council. Segura said that the IMF should draw on its previous experience in Nigeria, where it held emergency workshops to train government officials and lawmakers on anti-crisis policies for the financial sector.

¶9. (SBU) Comment. The completion of the first diagnostic study of Ukraine's largest banks was an important milestone in the fulfillment of the IMF's conditionalities. The NBU and GOU must now use their newly acquired information to swiftly recapitalize, or liquidate, banks. From discussions with the international donor community and private analysts that corroborate other information we have heard, it appears the NBU and GOU are still unprepared for the next step of implementation. They may not have the luxury of waiting much longer, if the state of the banking system is as dire as some fear. As it undertakes a review of Ukraine's performance in the months since the SBA was announced, the IMF team will need to hold Ukraine to its commitments, while at same time

helping it develop the means to put them into action.  End comment.

TAYLOR